Uncovering the risk conundrum: a strategic perspective

Introduction

Out of the many issues faced by the global hospitality industry, the access to capital has been recognized as a dominant factor. While financing opportunities have become more elusive in part due to an increasing competition for capital, hotel executives also appear to be inadequately equipped when asked to account for the value of their businesses. In too many cases, executives fail to back their claims as to the value of most of their strategic investments such as those in branding or in human resources programs. As a consequence of such inability to assess investments other than those in physical assets, and given the pressure of financial markets to grow earnings, the sole strategy embraced by the industry has been growth in terms of units. Though there currently exist many development opportunities in new markets, there is little doubt that such strategy cannot be sustained indefinitely. The question is then how will the hospitality company attract new capital if its only source of earning perishes? In other words, how can the hospitality firm better support its strategic decisions and prove the value it is creating with investments other than those in new properties? The purposes of this article are to review some advances in the corporate finance and strategy literature and to discuss the convergence of both fields around the concept of risk.

Corporate Finance & Risk Measures

There have been many efforts trying to capture the essence of risk in the corporate environment. The underlying reasons to such research efforts are twofold. Firstly, the concept of value in business has always been linked to the risk factor. Indeed, the foundations of corporate finance and strategic management have been rooted in the economic problems of profit maximization and risk reduction. Secondly, while both disciplines have common objectives, no model has been able to financially estimate the value created by strategies. As a consequence, a gap exists between what the financial community rewards and the value actually created by management.

The notion of risk has been theorized and researched in many discipline. While theories in microeconomics have greatly nourished the foundation of strategic management and corporate finance literature, the nature of the relationship between the two fields has remained ironic. Indeed, as modern corporate finance literature has evolved around theories of asset allocations that make the firm specific risks irrelevant, strategic management scholars have theorized processes and frameworks that help firms reduce their distinctive risk. In other words, finance scholars developed models suppressing the firm-specific factors while strategy students strived to develop theories around differentiation and competitive advantage. However, some recent attempts to reconcile the two fields of study have open up the way to new research projects.

The notion of risk

The major if not only goal of modern corporations is to continuously create and add value to its business. The notion of value as defined in a corporate setting is a function of the expected risk and return of an investment. However, while agreements tend to be achieved in the definition and in the recognition of some of the variables of the value equation, the most controversial issue remains the risk associated with the future investment. This risk, usually
referred to as risk premium, has been at the center of the development of modern finance, and thus, asset pricing theories.

Since the 1950s’, market-based models and theories have provided most of the currently used asset pricing and valuation models. The central argument of those models is based upon the founding work of Markowitz (1952) on portfolio selection, further developed by Sharpe (1964), Lintner (1965) and Mossin, (1966) for valuing single assets (Capital Asset Pricing Model – CAPM). The argument states that investors are only willing to value the market risk of assets (or systematic risk), since they have the opportunity of investing in diversified portfolios that would make firm-specific risk (unsystematic risk) irrelevant. According to this theory, investors are valuing securities premiums solely on the basis of market-derived factors, more precisely, the standardized covariance of the security to the market portfolio. Simply put, the model measures the variance of stock returns and assigns a risk coefficient (beta) to the firm that represents the degree of variability of the firm performance with the market performance. Hence, anomalies in the market, measured by abnormal returns, will be corrected, and the equilibrium will be kept. The underlying assumption being that markets are perfectly competitive, information is perfect, and assets transactions are free of distortions (or costs). Thus, these models are based on the economic theory of perfectly competitive markets, in which differentiation among firms within an industry is never lasting (Arrow & Debreu, 1954).

More recent empirical tests have proven the model to be a poor predictive estimate of assets value (e.g. Reinganum, 1981; Lakonishok and Shapiro, 1986). Other studies suggest that non-market factors are superior predictors. For example, Fama (1991, 1997) and Fama and French (1992, 1993, 1996) argue that, while market-based models explain a large part of the variation in stock prices, they are not predicting future value effectively. The authors suggest additional factors to enhance the models – firm-specific factors. In other words, Fama, French and other finance scholars are arguing that investors are valuing assets not only using market-related factors (such as the variance of the assets’ returns on the market), but also some firm-specific aspects, such as size or book-to-market ratio, as well as the notion of time and momentum. However, the empirical anomalies detected by the authors previously cited, and the suggested firm-specific factors are also being challenged due to their atheoretical nature (Chatterjee, Lubatkin and Schulze, 1999).

**Strategic Management & Assymetries**

Concepts in strategic management unanimously emphasize the role of risk and uncertainties as they pertain to the development of strategies. However, two different schools of thoughts have emerged and lead the field for the past two decades of so.

The school of competitive analysis (or positioning) is rooted in the economic theory of the firm that suggests that abnormal performances are competed away by rivals or new entrants to an industry. Thus, the competitive analysis theory strives to capitalize on market imperfection by leveraging some of the industry deficiencies that would prevent competition or new entrants from copying (Porter, 1980, 1996). Consequently, those theorist argue that strategy formulation and implementation should be driven by the industry structure, and focus on the latent market flaws to create sustainable abnormal performances.

The resource-based view (RBV) of the firm, however, suggest that firms are heterogeneous within industries and that it is those firm-level differences that allow some of them to
establish and sustain competitive advantage and superior performances (Rumelt, 1984; Barney, 1991; Collis, 1991). Yet, the same authors recognize the paradoxical character of inimitable resources and achievable strategies.

Recent developments in the RBV have tried to explain the process of shaping such inimitable resources by focusing on a more dynamic perspective (Hamel and Prahalad, 1994). As suggested by the authors, the development of unique capabilities is then based on sequences of path-dependent learning. This concept of path-dependent learning has been further developed into a conceptual model in the hospitality management literature (Olsen, West and Tse, 1998). This model, referred to as the co-alignment principle, suggest that firms achieve competitive advantage and superior returns when they are well aligned with their environment. According to the authors, this alignment is the result of consistent allocation of resources to those competitive methods that will best capitalize on the changes driven by environmental forces. Consequently, those inimitable and valuable resources are created through the strategic process of resource allocation that is based upon the recognition of the causal relationship between the environment dynamic and the value drivers affecting the firms.

**Strategic Management, Corporate Finance and Risk**

Important efforts have been made to understand the factors influencing the risk associated with the future performances of firms, and thus the risk that is affecting their current value. Corporate finance researchers have focused on factors such as size or market capitalization (Fama and French 1992, 1996). The main objectives of those studies were to find better predictive models to stock prices. Conversely, strategic management theorists have tried to uncover the underlying dimensions to sustained performance. Since the initial works of Schmalensee (1985) and Rumelt (1991), many studies have investigated the relative importance of industry and firms as determinant of performance (McGahan and Porter, 1997; Hawawini, Subramanian and Verdin, 2003). While their results revealed different level of significance for each factor, they still demonstrated that differences among industries and among firms within industries exist.

In an attempt to theorize a model capturing more of the risk associated with firm performance, Chatterjee, Lubatkin and Schulze (1999) have developed “a strategic conceptualization of risk premium”. This model depicts the causal relationship of tactics, strategies and compliance with norms, vis-à-vis the risk associated with the firm’s future performance (framed in Figure 1). The authors define tactical risk as information asymmetries that make investors averse to performance surprises. The techniques used to manage this kind of risk are financial tactics, hedges, and real options. While hedges and real options are commonly available tools, financial tactics require more involvement from the company. According to the authors, it includes earnings management, governance, and liquidity.
The second type of risk, the strategic risk, is mainly driven by imperfections in the market on which strategies try to build competitive advantage. This risk, thus, represents the ability of the firm to separate its performances from macroeconomic factors or industry-specific instability. Hence, lower strategic risks are achieved either by leveraging existing market imperfections or by creating new ones (Barney, 1991; Rumelt, 1984), or by establishing structural asymmetries within the industry (Porter, 1980).

The third dimension of risk, the normative risk, is defined as the risk premium (or penalty) a firm suffers if it fails to comply with norms or rules that it is expected to follow. Those kinds of rules represent the common expectations of investors, regulators, or other influential groups with regards to the behavior of the firm. Unlike the other types of risk mentioned above, the norms convey no influence on the risk premium, unless mismanaged.

The model suggested by Chatterjee, Lubatkin & Schulze presents many interesting concepts. Following the notion of risk theorized in corporate finance, the model aims to provide measurement tools that would better capture the degree of uncertainty associated with future returns. Indeed, the model presents relationships that could explain why firm's return varies within industries, as shown by Fama and French for example. In addition, the strategic risk described by the authors, and the mitigating relationship it has with the environment, is consistent with the notion of co-alignment presented by Olsen, West and Tse.

However, the model presented remains conceptual and is not totally adequate to bridge the gap between the current approaches to risk measurement and those of strategic management theories.

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1 Source: adapted from Chatterjee, Lubatkin & Schulze, 1999

2 This concept is similar to the notion of « buffer » suggested by Thompson (1967). Thompson posited that firms aim to develop strategies in order to buffer their core technologies (i.e. production function) from environmental uncertainty.
Toward a Strategic Model of Risk

As mentioned earlier, the definition of strategic risk suggested by Chatterjee, Lubatkin & Schulze is well supported by the current theories of strategy. Indeed, the asymmetries resulting from strategic decisions directly relates to the mitigating relationship described in the model. However, when considering the various concepts of strategy formulation and implementation, the construct of strategic risk needs to be broken down further, and discriminate between the mitigating relationship that are related specifically to the industry and to the firm.

The first sub-construct pertaining to the strategic risk refers to the industry specific factors that shape its attractiveness as argued by Porter (1980). These factors represent the entry barriers that protect the industry from external threats. These barriers can be defined in terms of what Rockart (1979) and Olsen et al. (1998) label as Critical Success Factors (CSF). CSFs’ are broadly defined as the factors (actions, processes, systems or policies) that are necessary to compete in an industry. In the hospitality industry, such factors could be a loyalty program, a training program, or a centralized reservation system. The relative bargaining power of the industry vis-à-vis its suppliers and its buyers, as well as the threats of entry or substitutes can thus be defined by an assessment of the CSF and of how firms perform on them.

The second sub-construct relates to idiosyncratic risk that depends on the core competencies and inimitable resources of each individual firm. As theorized by Barney (1991), the unique bundling of core competencies enable firms to gain advantage over their rivals, thus creating asymmetries within the industry. Typically, these bundles of resources are generated via investments in competitive methods. In terms of risk, the competitive methods represent not only an additional stream of cash flow, but also a way to mitigate the impact of certain macroeconomic events. For example, an investment in a creative human resource program could lower the negative impact that a shrinking pool of available labor force could have on the operating costs. As a consequence, the variability in cash flow of the firm would be less dependent upon external forces and more specific to the firm’s management.

The conceptual model presented in this article, adapted from Chatterjee, Lubatkin & Schulze, presents new research directions. While the constructs are relatively well defined, their dimensions remain too vague to properly develop operational measures and hypotheses. The concept of the macroeconomic events may also remain questionable as additional external forces may well interfere with the model. Indeed, environmental categories such as sociocultural, ecological, technological or political should logically be included in any risk assessment study. However, the hypothesized model provides an interesting framework to advance the convergence of corporate finance and strategic management disciplines. Further research in that direction are undeniably required if hospitality executives wants to improve the way they can communicate their strategic decisions to the investment community.

N. Graf, Professeur, Ecole Hôtelière de Lausanne
Email : nicolas.graf@ehl.ch
References